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FSI pragmatism kills two birds with one stone

The Wallis inquiry was based on classic economic theory whereas the Murray inquiry took a pragmatic approach that led to deft solutions to some longstanding conundrums in the banking sector.

Last week Professor Kevin Davis of the University of Melbourne took time out from speaking at conferences in Sydney to share some of his insights from being a member of the government financial system inquiry (FSI) that was chaired by David Murray.

Despite the different backgrounds of the FSI panellists – academic, banking and corporate – "we all converged fairly quickly on general agreement," Davis said in an interview.

"Obviously in some situations people want to go further than others but it wasn't hard to have solidarity even though we came at it from different ways. Resilience, fairness and efficiency were common goals to everyone, as were the importance of competition and consumer choice."

Arguably, the Wallis inquiry was based on the premise of a perfectly competitive world.

However, there is now less confidence in economic theory about assuming the optimality of competition particularly when it comes to the financial sector where market power and information asymmetry are such powerful and complicating forces.

Thus the Murray inquiry accepted the world isn't perfect and there will always be winners and losers from change. "We were very pragmatic. Pragmatism was our philosophy."

Disruptive business models

Davis accepts the major bank CEOs' insistence that they're fiercely competing with each other but argues that's within the context of them all requiring high return on equity (ROE) targets for their businesses.

That should attract new entrants to undercut them on price by targeting a lower ROE.

Unfortunately that hasn't been the case which Davis attributes to the big banks' economies of scale but he expects new technology will bring disruptive business models with different cost structures.

In the meantime, market concentration doesn't necessarily warrant intervention and Davis sees no point promoting inefficient competitors.

However, if some of the competitive advantage arises from implicit guarantees due to the perception that the banks are too big to fail, the FSI could justify making some pragmatic recommendations, not to make things perfect but to improve the current state of affairs.

'Unquestionably strong' capital ratios

"One of the things to reduce that competitive advantage is to reduce the extent of the implicit guarantee," said Davis.

The FSI did so by recommending that banks have "unquestionably strong" capital ratios that put them in the top quartile in the world.

If the banks hold more capital, there is less chance of them requiring government support so higher capital requirements reduce the benefits of any implicit guarantee.

"The increase in capital requirements is a resilience issue but it also has competitive effects," Davis said.

Likewise the recommendation that the five largest banks that use internal models to calculate their risk-weighted capital ratios have a floor on the risk weight of mortgages has "very significant competition undertones," he said, noting that the Basel Committee on Banking Supervision is working in the same direction.

Davis said he regards those two recommendations around bank capital as among the most important recommendations coming out of the FSI, along with "clarifying exactly what is the objective of superannuation and the focus on the need for improved retirement-phase products."

BANKING | **Tags:** Kevin Davis, FSI, David Murray, disruption, competition, Basel
Author: Marion Williams, mwilliams@financialpublications.com.au March 17, 2015
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